

Message Text

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SUBJECT: GOVERNOR BAFFI'S SPEECH AT THE 1977 ANNUAL
MEETING OF THE BANK OF ITALY

1. SUMMARY. GOVERNOR BAFFI, IN HIS ANNUAL SPEECH TO THE ASSEMBLY OF THE BANK OF ITALY, ONE OF HIS RARE PUBLIC APPEARANCES, GAVE HIS USUALLY CLEAR, CONCISE AND COGENT ANALYSIS OF ITALY'S ECONOMIC PROBLEMS. THE MAIN THEME OF THIS YEAR'S SPEECH WAS INFLATION. AFTER NOTING THE PROGRESS IN REDUCING IT DURING THE PAST YEAR, BAFFI SAID THAT THE DECELERATION SEEMS TO HAVE BEEN STOPPED AT THE CURRENT LEVEL OF ABOUT 13 PERCENT A YEAR. HE ATTRIBUTED MUCH OF THE SUCCESS TO DATE IN REDUCING INFLATION TO THE STABILITY OF THE LIRA WHICH HE, IN TURN, ATTRIBUTED IN PART TO SPECIAL CIRCUMSTANCES. THE GOVERNOR EMPHASIZED THE COSTS OF BOTH INFLATION AND THE FIGHT AGAINST IT IN TERMS OF THE WASTE OF REAL RESOURCES, AS SHOWN IN THE DECREASE IN GROWTH AND RISE IN UNEMPLOYMENT DURING 1977. THE FIGHT AGAINST INFLATION CAN ONLY BE WON IF THE SYSTEM OF WAGE INDEXATION IS ALTERED AND PUBLIC EXPENDITURES

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CUT. ON EXCHANGE RATE POLICY, GOVERNOR BAFFI STATED THE MOST IMPORTANT OBJECTIVES ARE: (1) STABILIZING THE EXTERNAL VALUE OF THE LIRA, WHICH IS AN ESSENTIAL ELEMENT IN CONTROLLING INFLATION; (2) MAINTAINING AN ADEQUATE LEVEL OF RESERVES; (3) MAINTAINING THE COMPETITIVENESS OF THE EXPORT SECTOR. FAIRLY GOOD RESULTS WERE ACHIEVED ON ALL THREE OBJECTIVES IN 1977. ON THE MONEY AND CREDIT SIDE, GOVERNOR BAFFI SAID THAT

THE RATE OF TOTAL CREDIT EXPANSION HAD ACCELERATED AND THAT THE GROWING LIQUIDITY OF THE ECONOMY WAS CAUSE FOR ALARM. HE SEEMED TO IMPLY THAT THE YIELDS ON GOVERNMENT SECURITIES OUGHT TO RISE; THESE PAY AT PRESENT LITTLE MORE THAN DEMAND DEPOSITS. HE NOTED THAT THE AVERAGE RATE ON BANK LOANS WAS LESS THAN THE RATE OF INFLATION AND THAT THE COST OF CREDIT WAS NOT THE ROOT PROBLEM IN THE PRIVATE SECTOR, AS IT IS SOMETIMWS ASSERTED TO BE.

END SUMMARY.

2. ECONOMIC DEVELOPMENTS IN 1977. DEPRECIATION OF THE LIRA CEASED AND INFLATION DECELERATED. CYCLICAL DEVELOPMENTS IN 1977 WERE GREATLY INFLUENCED BY FISCAL AND CREDIT MEASURES ADOPTED IN THE AUTUMN OF 1976. TAX AND PUBLIC SERVICE TARIFF INCREASES, AMOUNTING TO 5,000 BILLION LIRE FOR THE YEAR, REDUCED PRIVATE DISPOSABLE INCOME AND CAUSED PRIVATE CONSUMPTION TO FALL BEGINNING THE FIRST QUARTER 1977. INTERNAL DEMAND WEAKENED RAPIDLY WITH THE REVERSAL OF THE INVENTORY CYCLE. PRODUCERS SOUGHT TO MAKE UP FOR LOWER DOMESTIC DEMAND BY EXPORTING MORE, BUT, ALTHOUGH ITALIAN EXPORTS INCREASED THEIR MARKET SHARE, THEY GREW LESS THAN EXPECTED BECAUSE OF LOWER THAN PROJECTED GROWTH IN WORLD MARKETS. WITH THE DECREASE IN CAPACITY UTILIZATION AND WORSENING FINANCIAL DIFFICULTIES OF FIRMS, INVESTMENT FELL SHARPLY. INDUSTRIAL PRODUCTION DECLINED CONTINUOUSLY FROM FEBRUARY TO AUTUMN. THE UNEMPLOYMENT RATE ROSE TO 7.4 PERCENT.

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3. SUCCESS IN THE FIGHT AGAINST INFLATION WAS DUE MAINLY TO CYCLICAL AND EXTERNAL FACTORS: THE STABILITY OF THE LIRA, THE WEAKNESS OF DOMESTIC DEMAND, THE ABSENCE OF IMPORTANT LABOR CONTRACT RENEWALS, STABLE WORLD PRICES FOR OIL AND RAW MATERIALS. THE RATE OF INCREASE OF CONSUMER PRICES HAD DECLINED SUBSTANTIALLY BELOW WHAT IT WAS THE YEAR BEFORE, TO 14 PERCENT COMPARED TO 22 PERCENT IN 1976, AND FOR 1978 13 PERCENT IS FORECAST.

4. THE "SCALA MOBILE". THE HALT IN THE DECLINING TREND IN THE RATE OF INFLATION AROUND A DOUBLE DIGIT NUMBER RAISES THE QUESTION OF THOSE INERTIAL FACTORS THAT MAINTAIN INFLATION EVEN WHEN THE ORIGINAL CAUSES ARE SPENT. EMPIRICAL STUDIES SHOW THAT IN AUTONOMOUS INFLATIONARY IMPULSE IS PROLONGED BY THE INERTIAL FACTORS INHERENT IN THE WAGE INDEXATION SCHEME TO THE POINT OF RAISING THE GENERAL LEVEL OF PRICES IN TWO YEARS BY AN AMOUNT ONE-THIRD GREATER THAN WHAT WOULD HAVE RESULTED IF THE

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COST-OF-LIVING ADJUSTMENTS WERE MADE ONLY ONCE A YEAR
II(INSTEAD OF QUARTERLY).

5. IF THE PRESENT WAGE INDEXATION SCHEME MUST REMAIN IN
FORCE, THEN EVERY EFFORT MUST BE MADE TO AVOID, TO THE
EXTENT THIS IS IN OUR POWER, EVERY AUTONOMOUS INFLATIONARY
IMPULSE. NOT CONSISTENT WITH THIS REQUIREMENT WAS THE FACT
THAT IN 1977, WHILE GDP PER PERSON EMPLOYED INCREASED 1.3
PERCENT, GROSS WAGES PER CAPITA ROSE 6 PERCENT IN REAL TERMS.

6. THE APPROACHING RENEWAL OF IMPORTANT CONTRACTS POSES THIS
PROBLEM AGAIN IF THE CHANGE IN SALARIES STIPULATED IN
THESE CONTRACTS ARE TO BE DETERMINED INDEPENDENTLY OF STABLE
PRICES, GROWTH IN INVESTMENT, AND THE POSSIBILITY
OF INCREASING EMPLOYMENT OPPORTUNITIES.

7. ONLY AT THE COST OF GRAVE SACRIFICES IN THE FORM OF
RESTRICTION OF AGGREGATE DEMAND AND THE SUPPLY OF MONEY CAN
INFLATION BE SLOWED, WHEN THERE IS NO ASSISTANCE FROM
MEASURES THAT HAVE AN IMPACT ON THE UNIT COST OF LABOR, SUCH
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AS AN INCOMES POLICY IN THE STRICT SENSE, A "SOCIAL PACT,"
AN AGREEMENT ON PRODUCTIVITY AND MOBILITY OF LABOR.

8. IT WILL NOT BE POSSIBLE TO PROCEED ON THE SLOW ROAD TO GREATER PRICE STABILITY IF THE LABOR CONTRACT RENEWALS IN 1978 AND 1979 CONTAIN ADDITIONAL INCREASES IN REAL WAGES OR CAUSE AN INCREASE IN THE PUBLIC SECTOR DEFICIT BY TRANSFERRING THE BURDEN OF PENSION AND INSURANCE PAYMENTS TO THE STATE.

9. SOME CORRECTIONS TO THE MECHANISMS OF PUBLIC EXPENDITURES PROPOSED IN RECENT WEEKS GO IN THE RIGHT DIRECTION; OTHERS ARE NEEDED, BOTH IN THE INSURANCE SECTOR AND IN THE HEALTH SECTOR, WHICH WOULD LIMIT THE ACCUMULATIONS OF PENSIONS, REDUCE INDEXATION TO WITHIN THE POINT OF ONLY RESTORING PURCHASING POWER, AND AVOID THE WASTE OF DRUGS AND MEDICAL SERVICES.

10. THE COST OF INFLATION. FIRST, IT SHOULD BE NOTED THAT THE RECESSION OF LAST YEAR WAS LESS SEVERE THAN THE PRECEDING ONE IN 1974-75. IN THE PREVIOUS RECESSION, REAL GDP DECREASED BY 4.5 PERCENT BETWEEN THE THIRD QUARTER 1974 AND THE THIRD QUARTER 1975. BETWEEN THE FOURTH QUARTER 1976 AND THE FOURTH QUARTER 1977, THE FALL WAS 1.4 PERCENT. IN THE TWO PERIODS, UNIT LABOR COSTS IN INDUSTRY ROSE 41 PERCENT IN 1974-75 AND 21.5 PERCENT IN 1976-77.

11. THIS EVER-INCREASING COST OF LABOR IN RECESSIONARY PERIODS CONFIRMS THAT WHEN INFLATION IS COUNTERED ONLY WITH MONETARY AND FISCAL MEASURES, AS IN ITALY, THE FLOW OF REAL RESOURCES IS REDUCED, WHICH IN TURN INCREASES THE INFLATIONARY PUSH FROM THE COST OF LABOR SIDE.

12. IN A CONTEXT DIFFERENT FROM THE PRESENT ONE, IT COULD BE UNCLASSIFIED

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ARGUED THAT INFLATION CAN HAVE POSITIVE CONSEQUENCES SUCH AS REDISTRIBUTING INCOME FROM WAGES TO PROFITS AND WEALTH FROM CREDITORS TO DEBTORS. IN ITALY, THE REDISTRIBUTION OF INCOME FROM SALARIES TO PROFITS SIMPLY CANNOT OCCUR BECAUSE OF INDEXATION. THE REDISTRIBUTION OF WEALTH FROM CREDITORS, I.E., HOUSEHOLDS, TO DEBTORS, HAS OCCURRED, BUT IS LIKELY TO BE MUCH LESS SIGNIFICANT IN THE FUTURE BECAUSE NEW SAVINGS ARE FLOWING ALMOST EXCLUSIVELY INTO LIQUID ASSETS, THE YIELDS ON WHICH ADJUST TO THE RATE OF INFLATION.

12. FINALLY, IT IS TRUE THAT INFLATION HAS BEEN A TAX ON THE PUBLIC DEBT AND THE MONETARY BASE AND HAS BEEN A SIGNIFICANT SOURCE OF REVENUE FOR THE STATE; BUT THIS TAX, SURREPTITIOUS AND PROFOUNDLY UNJUST, HAS NOT FAVORED PRODUCTIVE PUBLIC INVESTMENT PLANS. ITS REVENUES HAVE GONE INSTEAD TO FILL FINANCING GAPS OPENED BY INEFFICIENCIES AND WATEFUL POLICIES.

13. MONEY AND CREDIT. UNTIL SEPTEMBER THE MAIN CREDIT AND

PUBLIC FINANCE AGGREGATES BEHAVED ROUGHLY IN LINE WITH THE PROFILE AGREED ON WITH THE INTERNATIONAL INSTITUTIONS. BUT IN THE FOURTH QUARTER, THE TREASURY DEFICIT GREATLY EXCEEDED THE AGREED LIMIT, DRAGGING WITH IT TOTAL DOMESTIC CREDIT.

14. TOTAL CREDIT EXPANSION DURING THE IMF STAND-BY YEAR (MARCH 1977-MARCH 1978) WAS 39,000 BILLION LIRE, 9,000 BILLION OVER THE LIMIT AGREED ON IN THE LETTER OF INTENT. THIS DISCREPANCY WAS ENTIRELY ATTRIBUTABLE TO THE TREASURY DEFICIT. THE INCREASE IN LOANS TO THE PRIVATE

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.....PRIVATE SECTOR WAS 14,500 BILLION LIRE, AN AMOUNT ALMOST EQUAL TO THAT IMPLIED IN THE LETTER-OF-INTENT. TO HAVE PREVENTED THE TREASURY DEFICIT FROM CAUSING TOTAL CREDIT EXPANSION TO BREAK THE MAXIMUM, IT WOULD HVE BEEN NECESSARY TO COMPRESS CREDIT TO THE PRIVATE SECTOR TO HALF THE ACTUAL AMOUNT. BEYOND BEING TECHNICALLY DIFFICULT, SUCH A MANEUVER, WHICH WOULD HAVE HAD TO HAVE BEEN ACCOMPLISHED WITHIN A FEW MONTHS, WOULD HAVE HAD DISASTROUS CONSEQUENCES FOR THE BANKS, THEIR CUSTOMERS, AND ECONOMIC ACTIVITY.

15. BECAUSE OF THE SALES OF TREASURY BILLS IN THE MARKET, CENTRAL BANK CREDIT TO THE TREASURY ACTUALLY DECREASED BY ALMOST 5,000 BILLION LIRE IN 1977, EVEN WITH A TREASURY DEFICIT LAGER THAN IN THE YEAR BEFORE. THIS OUTCOME, WHICH REPRESENTED

A REVERSAL OF A TENYEAR TREND, WAS MADE POSSIBLE BY THE INFLOW OF FOREIGN EXCHANGE AND THE LIQUIDATION OF THE PRIOR IMPORT DEPOSITS; BUT IT ALSO SHOWS HOW MONETARY BASE CREATION BY THE TREASURY DOES NOT CONSTITUTE THE ONLY WAY A PUBLIC SECTOR DEFICIT CAN BE INFLATIONARY, ESPECIALLY IN THE PRESENCE OF CEILINGS ON BANKS' LOANS.

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16. IF FOR THE GREATER PART OF 1977, ACTIONS TAKEN NEUTRALIZED THE MONEY-CREATING EFFECTS OF THE FOREIGN BORROWING BY THE BANKS AND THE GREATER PUBLIC SCTOR DEFICIT, CURRENT DEVELOPMENTS MAY PROVE TO BE BEYOND CONTROL, BY JUST USING THE MEASURES OF LAST YEAR. PRELIMINARY DATA INDICATE A TREASURY CASH DEFICIT OF 20,000 BILLION LIRE DURING THE SIX MONTHS ENDING LAST MARCH AND A GROWTH IN BANK DEPOSITS OF ABOUT 25 PERCENT, ANNUAL RATE, DURING THE PERIOD. IF PARLIAMENT DOES NOT BRAKE PUBLIC EXPENDITURES, IF THE STATE DOES NOT ALLOW A LEVEL OF INTEREST RATES ON TREASURY SECURITIES THAT ARE SUFFICIENTLY ATTRACTIVE TO THE MARKET, AND IF BANKS CONTINUE TO COMPETE FOR THE MARGINAL DEPOSIT AT A COST HIGHER THAN THE REVENUE ON THEIR MARTINAL ASSET, ONE CAN ONLY VIEW WITH ALARM THE MOMENT IN WHICH THE RECOVERY IN PRODUCTION WILL ACTIVATE THESE MONETARY BALANCES.

17. THE FALL IN ECONOMIC ACTIVITY AND IN INFLATION HAS PROMPTED DEMANDS FOR A PROMPT AND SUBSTANTIAL DECREASE IN THE COST OF CREDIT. THE PRIME RATE IS THE INTEREST RATE USUALLY CITED IN THIS CONNECTION; BUT BANK LENDING RATES, GREATER OR LESS THAN THE PRIME RATE, APPLY TO ONLY A FRACTION OF TOTAL LOANS. IN THE COURSE OF THE YEAR, IN ADDITION TO 7.7 BILLION OF NEW BANK LOANS AT AN AVERAGE INTEREST RATE OF 19.5 PERCENT, THERE WERE 3.5 BILLION IN FOREIGN EXCHANGE LOANS EXTENDED AT AN AVERAGE RATE OF ABOUT 9 PERCENT. THE AVERAGE RATE ON THE TOTAL FLOW OF NEW LENDING WAS 14.8 PERCENT, WHICH WAS LESS THAN THE RATE OF INFLATION, AS MEASURED BY ANY OF THE PRICE INDICES. AS LONG AS THIS RELATIONSHIP HOLDS INTEREST PAYMENTS ACTUALLY REPRESENT PARTIAL AMMORTIZATION. THIS SITUATION SUGGESTS THAT THE ROOTS OF THE PROBLEMS IN THE PRODUCTIVE SECTOR LIE ELSEWHERE THAN IN THE SCARCITY OR COST OF CREDIT.

18. /THE EXCHANGE RATE./ THE EXPERIENCE OF 1976 CONFIRMED
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THAT, IN THE CASE OF ITALY, EXCHANGE RATE DEPRECIATION IS OF LIMITED USE IN RE-ESTABLISHING EQUILIBRIUM, BOTH IN TERMS OF AMOUNT OF ADJUSTMENT AND DURATION. AFTER A MODEST INITIAL

ADVANTAGE, THE RAPID ADJUSTMENT OF INTERNAL PRICES TO THE EXCHANGE RATE PROMPTS A SPURT TO A HIGHER RATE OF INFLATION. GIVEN THIS CLOSE CONNECTION BETWEEN PRICES AND EXCHANGE RATE, THE STABILITY OF THE EXTERNAL VALUE OF THE LIRA IN 1977 PLAYED AN IMPORTANT PART IN CONTROLLING INFLATION.

19. DIRECT ADMINISTRATIVE MEASURES AND RELATIVELY HIGH DOMESTIC INTEREST RATES CONTRIBUTED TO THE INCREASE IN THE SUPPLY OF FOREIGN EXCHANGE BY INDUCING NET FOREIGN UNDEBTEDNESS. THE REBUILDING OF FOREIGN EXCHANGE RESERVES AS WELL AS THE STABILIZATION PROGRAM AGREED ON WITH THE IMF AND THE EEC CONTRIBUTED TO EXPECTATIONS OF EXCHANGE RATE STABILITY.

20. OVER THE ENTIRE YEAR 1977, THE LIRA WAS PRACTICALLY STABLE AGAINST THE DOLLAR. THE DEPRECIATION WEIGHTED

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.....WEIGHTED ACCORDING TO IMPORTS WAS LESS THAN THAT ACCORDING TO EXPORTS BECAUSE OF THE GREATER IMPORTANCE OF THE DOLLAR IN PAYMENTS FOR IMPORTS. THIS RESULTED IN A BOOST TO THE COMPETITIVENESS OF ITALIAN EXPORTS AT BUT MODEST COST IN TERMS OF INFLATION.

21. IN THE PRESENCE OF RAPID INFLATION, A POSSIBLE EXCHANGE RATE POLICY COULD HAVE BEEN TO INTERVENE LESS AND ALLOW THE LIRA TO APPRECIATE, WHICH WOULD HAVE SERVED THE OBJECTIVE OF REDUCING INFLATIONARY PRESSURES. THE POLICY CHOSEN, ALTHOUGH NOT IGNORING

THE GOAL OF CONROLLING INFLATION, ALSO AIMED AT TWO ADDITIONAL OBJECTIVES; REBUILDING RESERVES AND MAINTAINING COMPETITIVENESS IN EXPORT MARKETS.

22. THE APPROPRIATE LEVEL OF RESERVES SHOULD BE DETERMINED RELATIVE TO A FOREIGN TRADE VOLUME OF ABOUT \$100 BILLION A YEAR, MATURING DEBT REPAYMENT OBLIGATIONS, AND THE POSSIBLE NEED TO COUNTERACT UNPREDICATABLE OUTFLOWS OF CAPITAL.

23. MAINTAINING INTERNATIONAL COMPETITIVENESS IS ESSENTIAL
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FOR AN ECONOMY THAT EXPORTS ABOUT HALF OF ITS INDUSTRIAL PRODUCTION. ATTEMPTING TO LINK THE LIRA TO CURRENCIES OF COUNTRIES IN WHICH THE RATE OF INFLATION WAS MUCH LOWER THAN IN ITALY WOULD NOT BY ITSELF HAVE SUFFICINTLY REDUCED INFLATION IN ITALY. THE LESS AMBITIOUS LINE WAS TO FOLLOW APPROXIMATELY THE DEVELOPMENTS OF THE TWO OTHER IMPORTANT EUROPEAN CURRENCIES THAT ARE NOT ASSOCIATED WITH THE "SNAKE," I.E., THAT ARE DISSA-SSOCIATED WITH THE DM.

24. THE PROMPT REPAYMENT OF OFFICIAL DEBT OBLIGATIONS IS NOT THE RESULT OF A POLICY INSUFFICIENTLY SENSITIVE TO THE NEED TO FINANCE PRODUCTIVE ACTIVITY, BUT TO ASSURE THAT OUR CREDIT LINES ARE KEPT OPEN. PRIVATE BORROWERS ARE FREE TO BORROW ON THE MARKET PROVIDED THAT THEY OBTAIN COMPETITIVE TERMS AND CONDITIONS; IN THE PAST 8 MONTHS NEW PRIVATE BORROWINGS HAVE AMOUNTED TO \$700 MILLION.

25. FOREIGN EXCHANGE MANAGEMENT DURING THE CURRENT YEAR IS BASED ON ONE ELEMENT THAT IS CERTAIN AND ONE THAT IS ESTIMATED. THE CERTAIN ELEMENT IS \$4 BILLION OF DEBT REPAYMENT OBLIGATIONS, OF WHICH \$3.5 BILLION IS TO OFFICIAL INSITUTIONS. (ONE-THIRD OF OFFICIAL DEBT REPAYMENTS WERE MADE IN MARCH.) THE ELEMENT TO BE ESTIMATED IS THE CURRENT ACCOUNT SURPLUS, WHICH IS PROJECTED AT AT LEAST 2.0 TO 2.5 BILLION DOLLARS, WHICH DEVELOPMENTS SO FAR THIS YEAR SUPPORT. IT IS POSSIBLE, NEVERTHELESS, THAT OUR RATE OF FILATION AND THE RECOVERY IN PRODUCTION WILL PRODUCE LESS FAVORABLE EFFECTS ON THE BALANCE OF PAYMENTS.

26. THE EXCESS OF DEBT REPAYMENT OBLIGATIONS OVER THE CURRENT ACCOUNT SURPLUS WILL BE FINANCED BY A DRAWDOWN OF RESERVES OR NEW FOREIGN BORROWING, EITHER IN THE FORM OF SHORT-TERM BANK CREDIT OR MEDIUM TO LONG-TERM LOANS.

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27. THE TWO SOURCES OF SHORT-TERM FUNDS ARE SUBJECT TO MANY AND VARIED FORCES THAT ARE ONLY IN PART CONTROLLED DOMESTICALLY. IN PARTICULAR, CHANGES IN THE NET FOREIGN DEBTOR POSITION OF THE BANKS CAN INRODUCE INSTABILITY IN THE FOREIGN EXCHANGE MARKET AND LEVEL OF RESERVES. DURING RECENT MONTHS, THE SIZE AND DIRECTION OF OUR INTERVENTION HAVE GREATLY REFLECTED CAPITAL FLOWS PROMPTED BY CHANGES IN EXPECTATIONS FOR HE DOLLAR AND DOMESTIC AND INTERNATIONAL POLITICAL EVENTS.

28. IN THE AREA OF LONGER-TERM BORROWINT, THE MARKET SEEMS DISPOSED TO REFINANCE OR COUNTRY. THE PRIVATE MARKET'S ATTITUDE IS NEVERTHELESS INFLUENCED BY THE ATTITUDE OF THE INTERNATIONAL INSTITUTIONS FROM WHICH ITALY IS, OR IS ABOUT TO, REQUEST LOANS. THERE IS NO DISTINCTION, THEREFORE, IN PRACTICE, BETWEEN CONDITIONAL AND UNCONDITIONAL CREDIT. BECAUSE OF THIS CONNECTION, IT IS NECESSARY FOR US TO MAINTAIN OPEN OUR RECOURSE TO THE IMF AND THE EEC.HOLMES

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